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SUBJECT: AFTER 500 DAYS, THE QUESTION IS: CAN LULA GOVERN?

Classified By: Ambassador Donna Hrinak, reasons 1.4 B),D)

11. (C) SUMMARY. Lula's man-of-the-people rhetoric and heartfelt commitment to social progress quickly captured imaginations inside Brazil and abroad, but practical results of his first 500 days in office have been far less soaring. Without better economic news, stronger executive capacity and a firmer political base, his GoB may find itself falling into a crisis of governance by the second half of his term. Lula's fiscal and monetary policies have been all that the market wanted, but he has reaped no visible domestic rewards yet in the form of new growth, jobs, income or investment. His administration's executive ineptitude, and the ramshackle nature of its coalition alliances, are further factors that both contribute to and are themselves worsened by the economy's non-recovery so far. We expect pressure on Lula to mount further, with a fair chance he will feel forced to move to New-Deal-style spending programs in 2005. END SUMMARY.

The Personal Aura -----

12. (SBU) Lula's charismatic initial impacts, and his triumph in gaining market confidence after Brazil's 2002 crisis, have entered history as the first chapter of his presidency. What next? With more than a third of that presidency now past, his personal popularity is a healthy 60%, defying Brazil's absence of new growth and jobs, even if down from his high-80's of a year ago. Financial markets and institutions continue to lavish him with praise for the GoB's orthodox monetary/fiscal management. His constant foreign travel and diplomatic activism garner a high profile and mainly positive image worldwide, bolstering his and Brazil's claims to international leadership and thus appealing to nationalists on left and right. He has banked much good will on which to draw at home and abroad in terms of what he indisputably represents for Latin-American democracy and social aspirations. His comportment shines out as that of an uncorrupt, democratic, inclusive, charismatic but unassuming, down-to-earth negotiator. Yet Lula finished his first 500 days in office at his lowest domestic political ebb to date. What is the problem?

The Real Economy -----

13. (SBU) First and foremost, it's the economy. Brazil's macro-economic stabilization since 2002 has been a continuing true triumph of Lula's political will. He persistently endorses Meirelles' and Palocci's strict inflation and budget-surplus targets through 2005. Plainly, he has been won by the argument that fiscal/monetary loosening would risk forfeiting the gains that the Plano Real -- and especially the last year's sacrifices under the PT -- have brought Brazil. But palpable real-world results for Brazil's citizens have remained absent, and for Lula henceforth there will be no substitute for more growth, jobs, income, investment. Some recent data are positive, and forecasters concur that 3-3.5% GDP growth this year is likely. But they also generally agree that 3-3.5% will have only a marginal effect on jobs and income, and that that rate is unlikely to strengthen through 2006.

14. (SBU) Plus there are new economic concerns in the shape of outside uncertainties: Chinese demand, Fed interest-rate policy, the oil-price trend. These have helped erode the exchange rate by 10% since April. Further weakening could produce a halt - or even a reversal -- of the year-long decline of Brazil's benchmark SELIC interest rate. That in turn would hit the growth rate and might prevent the expected reduction in the debt/GDP ratio this year, which would be a truly crippling portent for Meirelles/Palocci.

15. (SBU) Brazil's external financial vulnerability is greatly down since 2002, thanks to superior current-account trends

and GoB debt-management. Still, the market is not Brazil's friend. If last year's benign global atmosphere were to shift, Brazil could fall to investor-herd fears despite its own best efforts. And those efforts, in the present climate of GoB political shakiness and inept governance, are far short of what they could be.

Executive Ineptitude

16. (C) Shaky leadership is an over-arching problem. Lula remains the undisputed arbiter of GoB policy differences, but his limitations are not being mitigated by the so-called "hard nucleus" of his closest Planalto advisors. On the contrary, this group of long-time Lula friends and PT veterans - e.g., Secretary General Luiz Dulci and Secretary of Government Communication and Strategic Management Luiz Gushiken - evidence no strategic vision or decisive executive competence. The one standout, Chief of Staff Jose Dirceu, was a virtual prime minister during the administration's first year, managing most key initiatives and coordinating congressional strategy. But his dramatic diminishment by the Diniz scandal has rendered Dirceu much less effective, leaving a vacuum that has sucked coherence and energy out of Planalto.

17. (C) Lula's executive problem extends through senior-personnel ranks. His first, tortuously drawn-out cabinet reshuffle has produced no rejuvenating results. And the process of installing new faces in ministries is still underway as part of Lula's coalition-reinforcing efforts, to the further detriment of efficient policy-making. Not by accident, those policy areas with the relatively best records under Lula - trade, macroeconomic, industrial, agricultural - are run almost entirely by non-PT ministers he appointed at the outset. Yet he has shown no readiness since then to reach out for expert talent beyond the PT.

18. (SBU) Meanwhile, ideological currents still run deep through the PT grass roots and into its senior echelons. Finance Minister Palocci's enlightened fiscal views are the exception: many, perhaps most of Lula's old allies still see the state as the main, natural, legitimate actor for directly implementing programs for national progress. At worst, this mindset has spawned fresh barriers to investors in the shape of GoB regulatory-agency and energy-model legislation. More generally, we suspect it causes Lula's GoB not to really know its own mind about its agenda. As former President Cardoso recently quipped: "I suppose the government must have a plan, but I cannot figure out what it is."

Ramshackle Political Base

19. (C) In the Congress, Lula has slipped backwards. His ability to push legislation depends on the unity of an unwieldy, PT-led coalition which includes parties that are all over the map in terms of ideology and seriousness. On paper the coalition is ample enough to carry the day on most votes, but in reality fragmentation and rebellion are becoming the norm. The Diniz scandal, together with unhappiness on the right with lack of growth and on the left with lack of progress on the touted social agenda, brought Lula a major legislative defeat in early May. More may come. The fragile coalition is barely held together by Lula's charisma and promises of pork and government jobs. Passage of his pension and tax bills in 2003 hinged on support from opposition parties, and he may hope to reach out more in future to the PSDB, which is likeminded on various platform issues. But this will further dilute coalition discipline and the efficacy of legislation produced by barter.

110. (SBU) At the local level, GoB/PT prospects in October's municipal elections have faded. The PT has always been an urban party (its mayors run 10 of Brazil's largest cities but only a tiny percentage of smaller municipalities), and early in the Lula government there was PT hope for a breakthrough bandwagon effect. After the administration's last four months of difficulties, however, PT leaders are no longer willing to predict large gains and are digging in for tough challenges to party incumbencies, notably Sao Paulo, where a loss would be iconic for Lula and the PT.

111. (C) Foreign policy is one area which Lula and his diplomats doubtless view as one of unalloyed triumph. In reaching for a weightier world role, they have mirrored previous Brazilian ambitions. The outcome of the Cancun WTO talks, the dilution of the FTAA process at Miami, the formation of the G-20 Group, have had no downside, in their view. But much of what Itamaraty portrays as Lula's personal impact on the world scene is plain fanciful, e.g., his grandiloquent plan for a tax on arms transactions to go into a hunger-relief fund. And his foreign policy and travels may hold future risk for his image, e.g., if Venezuela goes critical or if Itamaraty doctrinaires ultimately stymie FTAA negotiations.

112. (C) It is not easy to see Lula making a strong recovery in his next 500 days. Conversely, it is not hard to envision further political and economic slippage. Worst-case: if Lula's domestic political standing worsens, and external economic developments turn bad, Brazil could be back within months to a deteriorating economic/financial spiral. More-likely case: growth picks up modestly and Brazil avoids external economic buffets, but there still is little sense of new momentum or relief through year's end. If either of these scenarios combines with a poor PT election result, what might be Lula's political and policy follow-on?

113. (C) Lula's orthodox economic policy remains exactly what most outside observers have counseled, but he and the PT are unlikely to soldier on with it indefinitely, absent palpable returns. This would be especially the case if an external shock sparks a "hot-money" investor flight that could be perceived as confiscating the gains of Brazilians' past sacrifices. Should GDP not pick up convincingly by year's-end, arguments for a policy adjustment from "Herbert Hoover" policies towards "Roosevelt New Deal"-style public-works employment, with a priority on useful infrastructure projects like railroads and water-treatment, may become hard to resist.

COMMENT

114. (C) Are Lula's struggles just a spring slump, or a presage that his team is headed for a losing season? Arguably, no party fresh like the PT to national power could have made a fast start in a nation like Brazil, less than twenty years emerged from dictatorship, with its primitive and corrupt feudalities, undisciplined and unprincipled political parties, and inadequately-established state institutions generally.

115. (C) Lula-backers can still hope that Brazil's GDP growth this year will be sufficient to ease social pressures; that the PT will do well enough in October's elections to solidify its coalition; that the President will thereafter recruit new ministers and key figures, re-launch his legislative program at the start of 2005, and, learning from past missteps, make an expeditious success of the further reforms vital for Brazil's economy to break through and attain its long-term potential. The glum alternative opinion is that he and the PT already are showing they lack the personnel, platform, party, political power, and general conditions to carry out their transformational "project" for Brazil, period.

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